No. 12143

In the United States Court of Appeals for the Ninth Circuit

WALTS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 47-61) are unreported.

JURISDICTION

This petition for review (R. 69-77) involves federal declared value excess profits and excess profits taxes for the taxable year 1942. On October 27, 1944, the Commissioner of Internal Revenue mailed to taxpayer a notice of deficiency in the total amount of $29,711.20. (R. 11-20.) Within 90 days thereafter and on January 23, 1945, the taxpayer filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code. (R. 5-20.) The decision of the Tax Court redetermining

the deficiency was entered April 10, 1947. (R. 66.) This case is brought to this Court by a petition for review filed July 7, 1947 (R. 69-77), pursuant to the provisions of Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTIONS PRESENTED

1. Whether the Tax Court properly entered its decision based upon findings of fact and conclusions of law by a judge of the Tax Court who did not conduct the hearing or trial of the case, and accordingly whether or not the Tax Court should have granted taxpayer's motion for a rehearing *de novo* under such circumstances.

2. Whether in recomputing taxpayer's deficiencies in declared value excess profits and excess profits taxes for the taxable year the Tax Court should have deducted taxpayer's postwar excess profits tax credit, provided by Sections 780 and 781 of the Internal Revenue Code.

3. Whether, in determining a reasonable allowance for salary expenses under Section 23 (a)(1) (A) of the Internal Revenue Code, the Tax Court was required to accept as conclusive evidence of the cost to taxpayer had other employees done the work done by the officers whose salaries are in question.

4. Whether the Tax Court's findings as to a reasonable allowance for salaries under Section 23 (a)(1)(A) of the Internal Revenue Code are clearly erroneous.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations may be found in the Appendix, *infra*.

STATEMENT

The facts as found by the Tax Court are substantially as follows:

Taxpayer, Walts, Inc., known also by the name Aero Alloys, has its principal office and place of business in Los Angeles, California. (R. 47.)

Taxpayer's president, Walter J. Cunningham is a veteran of World War I. Prior to entering the service, he had had a high school education, spent two years at business college, and had one year at Williams College. When he was discharged, he worked one year as a claims adjuster. In 1920, he became associated with his father in the lumber business in Rochester, New York. From 1922 to 1925, he was secretary and treasurer of the company, receiving compensation of from $12,000 to $15,000 annually, approximately one-half in salary, the remainder in commissions and bonuses. The lumber company underwent reorganization under Section 77B of the Bankruptcy Act in 1932 and thereafter continued in business until dissolution in 1935. (R. 48.)

Cunningham then went to the West Coast, in October 1936, and became a salesman with a lumber company there doing much the same kind of work he had done in Rochester, receiving a salary of $270 monthly. (R. 48.)

Subsequently, he met Walter E. Withers and J. Robert Muratta. Withers owned some foundry equipment. Cunningham looked the equipment over and suggested moving it to an industrial section and organizing a foundry corporation. Taxpayer was thereafter incorporated under the laws of California, April 24, 1940, with an authorized capital stock of $25,000, divided into 2,500 shares at a par of $10. (R. 48-49.)

Taxpayer's articles of incorporation were executed by Cunningham, Withers, and Muratta, who were named therein as its directors. Withers was elected

president; Muratta, vice-president; Cunningham, secretary-treasurer. Withers acquired 100 shares of stock by paying $500 and transferring to the taxpayer foundry equipment worth $600. Katharyn S. Cunningham, wife of Walter J., acquired 50 shares by paying $500 borrowed from her father. Walter J. Cunningham did not invest in taxpayer's business and was not a stockholder at any time. (R. 49.)

Under date of February 26, 1941, taxpayer and the Aluminum Company of America (ALCOA) entered into two licensing agreements, wherein ALCOA licensed taxpayer to use its patented processes for the thermal treatment of casting of aluminum alloy compositions, in consideration of certain royalties. (R. 49.)

At a meeting of taxpayer's board of directors, March 31, 1941, Cunningham informed the board that Katharyn S. Cunningham's efforts had been responsible for procuring the licensing agreements, and that she had incurred obligations and expenses to the extent of $1,140 in obtaining them. The board resolved that she be reimbursed. It also authorized the leasing or construction of an adequate plant and the purchase and installation of equipment to maintain the plant for the manufacture of aluminum alloy products. To obtain needed funds, the directors authorized the borrowing of $8,500 from the wife of Elmer D. Morse, which was done, taxpayer giving its note for the loan. Thereafter a building was leased. (R. 49-50.)

At the meeting the board also authorized payment of salaries—$200 per month each to Morse and Cunningham. It accepted Muratta's resignation as a director and vice-president and appointed Morse in his stead as a director. Withers also resigned as a director and president. Cunningham was named president, Morse, secretary and treasurer. (R. 50.)

At or about the time of the March, 1941 meeting,

Katharyn S. Cunningham and Morse became the owners of the 150 outstanding shares of taxpayer's stock. This ownership prevailed throughout the remainder of 1941 and during 1942. (R. 50.)

On January 5, 1942, the stockholders of taxpayer had a meeting and elected Walter J. Cunningham, Katharyn S. Cunningham, Dorothy M. Morse, and Elmer D. Morse to be directors. At a directors' meeting on the same day the board resolved that Cunningham and Morse each be paid at the rate of $24,000 per annum for their services, effective as of January 1, 1942. Cunningham was elected president; Mrs. Cunningham, vice-president; Morse, secretary-treasurer; and Mrs. Morse, vice-president. (R. 50-51.)

At a meeting held April 10, 1942, the directors authorized the purchase and installation of a new heat treating furnace at a cost of approximately $5,000 and the erection of an addition to taxpayer's plant, together with additional necessary equipment, to cost about $3,000. (R. 51.)

On June 12, 1942, the directors authorized taxpayer's president and treasurer to erect an additional building on the north side of taxpayer's plant and to purchase additional equipment therefor. (R. 51.)

At a meeting held August 14, 1942, taxpayer's directors adopted a motion "that each director be paid the sum of $25 for attendance at each meeting of the board". (R. 51.)

On August 28, 1942, the Aluminum Company of America wrote taxpayer that because of the direct and immediate relationship of the heat treatment of aluminum alloy castings to war production, the license agreement of February 26, 1941, was to be royalty-free from July 1, 1942, until the cessation of hostilities. (R. 51.)

At a meeting, August 28, 1942, the directors resolved that Cunningham and Morse each be paid at the rate of

$36,000 per annum for their services, effective as of September 1, 1942. (R. 51-52.)

Between August 28, 1942, and December 30, 1942, inclusive, ten recorded directors' meetings were held, at each of which all four directors were present. Discussions dealt chiefly with reports on the increase in taxpayer's business, bank loans, construction of additions to taxpayer's plant, purchase of necessary additional equipment, the authorization thereof, and of other expenditures; also that arrangements had been made for a line of credit with the Bank of America, up to $25,000. (R. 52.)

During 1942, taxpayer's business consisted entirely of manufacturing and sale of airplane parts as a subcontractor for aircraft manufacturers engaged in war work, the parts being of aluminum made with the heating processes covered by taxpayer's licensing agreements with ALCOA. (R. 52.)

In 1940, taxpayer's gross sales were $1,227.38, and it sustained an operating loss for the year of $1,123.58. No salaries were paid by taxpayer to any of its officers or directors in that year. Gross sales in 1941 amounted to $39,996.19, and the Commissioner determined that taxpayer had an adjusted net taxable income of $1,-205.92. In 1941, taxpayer paid salaries to its officers of $3,300, $1,650 each to Cunningham and Morse, both of whom devoted their entire time to taxpayer's business and operations. During the calendar year 1942, taxpayer's gross sales amounted to $434,363.44, and its net profit before payment of salaries to its officers amounted to $85,828.39. Taxpayer paid officers' salaries that year of $56,000, evenly divided between Cunningham and Morse, both of whom devoted their full time to the business and operations of taxpayer. In addition, each of the four directors was paid $250 during 1942 for attendance and services at directors' meet-

ings, at the rate of $25 per director for each of the ten meetings held during the year. (R. 52-53.)

No dividends were paid by taxpayer at any time between April 24, 1941 and December 31, 1942, inclusive. The gross sales, as shown by taxpayer's books, reflect the following monthly balances between August 31, 1941, and December 31, 1943 (R. 53):

Aug. 31, 1941	$ 7,208.87	Nov. 30, 1942	$369,684.11
Sept. 30, 1941	10,357.09	Dec. 31, 1942	434,363.44
Nov. 30, 1941	26,789.91		
Dec. 31, 1941	39,996.19	Jan. 31, 1943	$ 68,469.17
		Feb. 28, 1943	151,118.93
Jan. 31, 1942	$ 11,982.38	Mar. 31, 1943	246,500.53
Feb. 28, 1942	25,321.67	April 30, 1943	337,799.36
Mar. 31, 1942	42,455.69	May 30, 1943	399,247.60
April 30, 1942	65,515.58	June 30, 1943	474,109.72
May 31, 1942	91,019.92	July 31, 1943	551,789.76
June 30, 1942	126,858.37	Aug. 31, 1943	617,334.03
July 31, 1942	170,755.49	Sept. 30, 1943	685,084.75
Aug. 31, 1942	215,347.22	Oct. 30, 1943	776,982.08
Sept. 30, 1942	263,711.51	Nov. 30, 1943	873,646.35
Oct. 31, 1942	311,958.67	Dec. 31, 1943	964,862.25

In determining the deficiencies, the Commissioner disallowed $36,000 of the total amount of $56,000 paid as salaries to Cunningham and Morse in the taxable year 1942. The Commissioner also disallowed directors' fees totalling $1,000, paid to the four directors for attendance at ten meetings, at the rate of $25 a meeting. (R. 54.)

During 1942 both Cunningham and Morse devoted from 12 to 14 hours each day to their duties as president and secretary-treasurer. Cunningham performed a variety of duties that year, including those of general and production manager, sales promotion, metallurgist, shipping clerk and inspector of castings. Morse, who had operated several sporting goods stores prior to his association with taxpayer, handled the financial end of the business, office detail, and matters pertaining to the scheduling of parts out of the foundry. Morse severed his connections with taxpayer in 1943. (R. 54.)

The profit and loss account appearing on taxpayer's books for 1941 and 1942 reflects the following (R. 54):

	1941	1942
Sales	$39,996.19	$434,363.44
Cost of goods sold	31,261.93	329,163.97
Gross profit	8,734.26	105,199.47
Compensation of officers	3,300.00	56,000.00
Other expenses	3,950.04	19,371.08
Net profit (before taxes)	1,484.22	29,828.39

The Tax Court found that a reasonable allowance for the salaries for services rendered by Morse and Cunningham in 1942 was $10,000 each per annum. The court also found that a reasonable allowance for directors' fees for services rendered by the four directors of taxpayer at the ten meetings they attended between August 28, 1942, and December 31, 1942, inclusive, was $25 per meeting, a total of $1,000. (R. 54-55.)

Taxpayer appeals from the findings of the Tax Court, having filed its petition for review July 7, 1947. (R. 3.)

SUMMARY OF ARGUMENT

1. Congress contemplated in creating the Tax Court that the personnel of a division to which a case is assigned to submit findings in a report to the full court might, for various reasons, have to be changed during the course of a hearing, determination, or final report to the Tax Court. Accordingly, it vested the presiding judge with authority to make substitutions as to judges assigned to the various divisions of the court. A formal order is not required in such substitutions. In view of Tax Court procedure in the promulgation of its decisions, it is not material whether or not the judge who hears the evidence makes the report to the court which may or may not become the basis for the court's decision, so long as the report is based on the evidence. In providing for decisions based upon the report of one judge, and in providing for the appointment of commissioners, the statute contemplates that the judge who

makes a report of findings to the court may not be the same one who heard the case. The procedure followed herein was authorized by the controlling statutes. Taxpayer was not denied due process of law by the procedure followed. It received a hearing in a substantial sense, which is all that is required. Furthermore, taxpayer makes no valid showing of prejudice.

The Tax Court could not allow taxpayer a ten percent postwar credit in computing the deficiency, since it did not have jurisdiction over the credit.

The fact that taxpayer's officers did work that might have been done by many other employees does not necessarily support the reasonability of compensation paid them. It is clear that one of the officers could not do the full time work of eight men and therefore merit the full wages payable to all eight.

What constitutes a reasonable allowance for salary expenses is a matter of fact. The Tax Court properly took many factors into account in determining what would constitute a reasonable salary under the circumstances, and determined that the evidence presented a studied plan of distributing profits in the guise of salary. Ample evidence supports this conclusion. Neither officer had special qualifications; war conditions contributed to abnormally high profits, not the services of the officers; services were not the guiding factor in determining salaries; no dividends were paid in the taxable year; salaries were paid in direct proportion to family stockholdings in the corporation. The Tax Court's findings are supported by ample evidence and should not be disturbed.

ARGUMENT

I

Taxpayer Was Not Denied Due Process of Law Because the Judge Who Took Testimony Did Not Write the Findings of Fact and Opinion

Taxpayer first raises the point that due process of law required a decision by Judge Black, who heard the case, or in the alternative that a trial *de novo* should have been held. It also contends that Sections 1116, 1117(b), and 1118(a) of the Internal Revenue Code (Appendix, *infra*) were violated. (Br. 10-21.) There is no merit to any of these contentions.

The Tax Court exists under, and its powers and duties are defined by Sections 1100-1146 of the Internal Revenue Code, as amended by Section 504 of the Revenue Act of 1942, c. 619, 56 Stat. 798 (26 U.S.C. 1946 ed., Secs. 1100-1146). It is composed of sixteen judges (Section 1102(a)), who designate one of their number to act as presiding judge (Section 1103(b) (Appendix, *infra*)). The presiding judge has authority under Section 1103(c) (Appendix, *infra*) to divide the Tax Court into divisions of one or more judges, to assign the judges thereto, and in the case of a vacancy, absence, or inability of a judge to serve on a division to assign another or other judges to the division. Section 1118(a) provides that the division to which a proceeding is assigned shall hear, determine, and make a report consisting of findings of fact and opinion (Section 1117(b)) of its final determination. The report of the division becomes the report of the Tax Court within 30 days after it is made unless within such period the presiding judge directs that the report shall be reviewed by the whole Tax Court Section 1118(b).

It is thus obvious that Congress contemplated that a change in the personnel of a division might become necessary for various reasons during the course of the

hearing, determination, or final report to the Tax Court, of a proceeding assigned to the division and that it vested the presiding judge with the authority to make a substitution of judges, in the division or to transfer the proceeding to another division as an inter-office matter. There is no requirement for a formal order transferring the proceeding from one judge to another or for notice to the taxpayer of the transfer. The record in this case does not disclose the administrative reason for the transfer of this case, but whatever the reason the presiding judge did not exceed his authority in transferring the present case from Judge Black to Judge Harlan without notice to the taxpayer.

It is thus obvious that under the statutory provisions the taxpayer has no cause for complaint. This is particularly true, since the report of the division, consisting of suggested findings of fact and opinion is made to the whole Tax Court, rather than to the parties. Only after it has been examined by the presiding judge, and informally by the other judges during a thirty-day period,[1] does it become the report of the Tax Court. Where unreviewed the division's report is thus accepted by the whole court, and where reviewed, the division's report is rejected and is not even a part of the record. Section 1118(b). In view of this procedure it is manifestly immaterial whether or not the judge who took the evidence makes the report to the Tax Court, so long as the report is based on the evidence which is stenographically reported insofar as it consists of testimony (Section 1116), and on the argument, as it was here. Indeed, as has been shown, the statute contemplates that the judge who makes the report may not be the same judge who heard the case. This is shown,

[1] We are informed that the report of a division is circulated among all the judges each of whom has an opportunity to submit any objections thereto to the presiding judge, or to request a review by the whole court.

further, by the fact that where the whole Tax Court reviews, fifteen of its judges have not heard the evidence although they make findings of fact and render an opinion thereon. This procedure is authorized by statute and is well established. Also, the Code even authorizes the presiding judge to appoint an attorney on the court's legal staff to act as commissioner in a particular case. Section 1114(b)(Appendix, *infra*). His role, like commissioners in the Court of Claims, would undoubtedly be to take the evidence and render suggested findings thereon to the Tax Court Section 1114(b).

Contrary to taxpayer's argument, Sections 1116, 1117(b), and 1118(a) of the Code, were complied with. The hearing presided over by Judge Black at which the evidence was taken was a public one, and the testimony was stenographically reported. The report of Judge Harlan, the division to whom the case was assigned in full accord with the statutory procedure, to the whole Tax Court contained findings of fact and opinion and this report was adopted by the whole Tax Court as its report on which decision was entered. In view of other provisions of the Code already discussed, Section 1118 (a) obviously does not mean that a case may not be reassigned to another division for a report after one division has heard the evidence.

Since the procedure followed in this case was authorized by the controlling statutes, it remains to consider only whether this procedure withheld due process of law from the taxpayer. *Morgan* v. *United States,* 298 U. S. 468, the only case relied on by the taxpayer, shows clearly that due process of law was accorded the taxpayer. The complaint therein was that the Secretary of Agriculture made a rate order without having heard or read any of the evidence and without having heard the

oral arguments or read the briefs. In this connection the Court said in the *Morgan* case that (pp. 481-482)—

> the weight ascribed by the law to the findings—their conclusiveness when made within the sphere of the authority conferred—rests upon the assumption that the officer who makes the findings has addressed himself to the evidence and upon that evidence has conscientiously reached the conclusions which he deems it to justify. That duty cannot be performed by one who has not considered evidence or argument. It is not an impersonal obligation. It is a duty akin to that of a judge. The one who decides must hear.
>
> This necessary rule does not preclude practicable administrative procedure in obtaining the aid of assistants in the department. Assistants may prosecute inquiries. *Evidence may be taken by an examiner.* Evidence thus taken may be sifted and analyzed by competent subordinates. Argument may be oral or written. The requirements are not technical. But there must be a hearing in a substantial sense. And to give the substance of a hearing, which is for the purpose of making determinations upon evidence, the officer who makes the determinations must consider and appraise the evidence which justifies them. * * * (Emphasis supplied.)

In this case there was a hearing "in a substantial sense." Clearly the deciding judge herein considered the reported evidence in making his findings of fact, even though he did not preside at the hearing where the evidence was received. And there is no allegation that he did not consider the briefs, this constituting consideration of argument, which as the Supreme Court pointed out might be oral or written. The taxpayer was not denied due process of law, as explained in the *Morgan* case.

The problem of one judge of the Tax Court hearing

a case, another writing the opinion has occurred before. Taxpayer perhaps overlooks the point that all Tax Court opinions are the result of just such a delegation as the Supreme Court condoned in the *Morgan* case. Decisions are not made by the judges who hear cases or make findings therein. Their findings are embodied in a report to the Tax Court, which may or may not then become the report of the Tax Court, under Section 1118 (b) of the Internal Revenue Code. In *Davidson* v. *Commissioner,* 91 F. 2d 516 (C.A. 5th), evidence was taken before two members of the Board of Tax Appeals. One of them later died; the other resigned. A third Board member made findings of fact and rendered an opinion which was reviewed and adopted by the Board. The court approved this procedure, stating (p. 518):

> It would unnecessarily, and to no good purpose, complicate and delay the disposition of business by the Board if proceedings before one who had ceased to be a member had to be abandoned and held for naught. It was within the sound discretion of the Board to enter judgment on the findings of facts and opinion of Board member Murdock [the third member noted above]. We find no abuse of discretion in this respect.

Accord: *Garden City Feeder Co.* v. *Commissioner,* 75 F. 2d 804 (C.A. 8th). Compare *Askania Werke, A. G.* v. *Helvering,* 96 F. 2d 717 (C.A. D.C.). It seems clear that the Tax Court acted within its discretion in entering a decision on Judge Harlan's report, and in denying taxpayer's "Motion for Rehearing *de Novo.*" (R. 61-65.)

Both in its brief and in its motion for rehearing below, taxpayer has made the allegation that it was prejudiced by the reassignment of the cause for findings of fact and opinion. We do not consider this allegation alone a sufficient showing of prejudicial error. The

fact that the Tax Court sustained the Commissioner's determination of deficiency is not in itself prejudicial error. In the motion for rehearing, taxpayer also alleged prejudice in the court's failure to consider certain evidence. This is discussed under point III, *infra*.

II

The Tax Court Properly Denied Taxpayer's Motion to Correct Its Decision in Respect to the Ten Percent Postwar Credit

Taxpayer contends (Br. 22 *et seq.*) that the Tax Court erred in failing to allow a ten percent postwar credit under Sections 780 and 781 of the Code (Appendix, *infra*) against the Commissioner's recomputation of deficiency. In support thereof, taxpayer relies on language in *Altschul's, Inc.* v. *Commissioner,* 9 T. C. 697, acquiescence, 1948-1 Cum. Bull. 1. That case is, however, not in point here. The question there was whether the postwar credit was sufficiently ascertainable at the end of the tax year so as to be taken into account in determining the taxpayer's accumulated earnings and profits at that time and the Tax Court's discussion of Sections 780 and 781 was related to this problem only. The case of *California Vegetable Concentrates, Inc.* v. *Commissioner,* 10 T. C. 1158, acquiescence, 1948-2 Cum. Bull. 1, is in point, and therein the full Tax Court, in a reviewed opinion held (pp. 1171-1172) that it did not have jurisdiction over the postwar excess profits tax credit, stating that it had no place in the computation of a deficiency, and that instead it is a credit to the tax account of a taxpayer for which bonds or cash may be issued. That this is a proper conclusion is clear from a reading of the provisions of Sections 780 and 781 of the Code. The allowance of the credit is under the jurisdiction of the Secretary of the Treasury only.

III

It Was Not Error to Minimize Evidence That Taxpayer's Officers Did Work Which Would Otherwise Have Acquired the Services of Many Additional Employees

Taxpayer argues (Br. 25 *et seq.*) that the Tax Court erred in failing to find, in accordance with undisputed evidence, that taxpayer would have been obliged to pay more than $42,000 to others, had it hired others to perform the services performed by Cunningham. Also (Br. 30), taxpayer in a note seeks a concession of correctness of its statements from the Commissioner. If taxpayer wishes the Court to consider the briefs in the Tax Court, we have no objection to augmentation of the record to include them.

Taxpayer exhibits some irritation that the Tax Court found that "an unimpressive attempt was made to prove that petitioner would have had to pay more than $28,000 if it had hired others to do the work performed by Cunningham, * * *." (R. 60.) We also consider the attempted proof unimpressive and not entitled to any weight.

Taxpayer sought to prove that Cunningham did the work of a metallurgist, a shipping clerk, a general manager, an inspector of castings, a superintendent of production, and a salesman, the probable salaries of which for full-time work are offered, as well as pattern-maker and invoice clerk. This is an impressive role of duties, the work of eight men. Working full time they would have done work which would constitute a memorable achievement for one man. We do not seek to minimize evidence that Cunningham worked many hours each day. We simply question whether he did the compensable work of eight men full time each day. We consider the task impossible, and argument based upon such evidence absurd. Obviously the Tax Court felt the same way. Where evidence, even though uncon-

tradicted is contary to human experience, the Tax Court is of course not required to accept it at face value. The prejudicial error of the Tax Court is not only not self-evident on this score, it is self-evident that the Tax Court would have committed prejudicial error had it given weight to taxpayer's evidence as to the many men supposedly displaced by Cunningham.

IV

The Tax Court Properly Concluded That $10,000 Was a Reasonable Compensation for Morse and Cunningham

Lastly, on the merits of the case, taxpayer contends that the Tax Court erred in finding that payments to Cunningham and Morse in the taxable year were excessive of reasonable compensation. Section 23(a)(1)(A) of the Internal Revenue Code (Appendix, *infra*) provides for the deduction of ordinary and necessary business expenses, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." The applicable Treasury Regulations (Treasury Regulations 111, Section 29.23(a)-6 (Appendix, *infra*)), similarly provide.

What constitutes a reasonable allowance for compensation payments is a factual question for the Tax Court. *Kennedy Name Plate Co.* v. *Commissioner,* 170 F. 2d 196 (C.A. 9th). Unless the Tax Court's decision then is clearly erroneous, its determination should not be disturbed on review.

Many factors may be taken into account in attempting to ascertain in given circumstances what is a reasonable salary for the services rendered. See *Commercial Iron Works* v. *Commissioner,* 166 F. 2d 221 (C.A. 5th); 4 Mertens, Law of Federal Income Taxation, Section 25.51, *et seq.* In the case at bar, the Tax Court noted the following in determining whether amounts paid Morse and Cunningham were reasonable; that neither had any

special qualifications for the business; that the principal factor in the success of the business was not their efforts but the licensing agreement with ALCOA and the wartime demand for their products; that the services of Morse and Cunningham were not the "guiding factor" which influenced the setting of the salaries; that no dividends were paid in the period in question; that the Cunningham and Morse family holdings were equal, and that equal compensation was paid through the two officers to each family, such payment being consistent with payment for services. The Tax Court finally concluded that the taxpayer had not borne the burden of showing that Morse and Cunningham could reasonably be paid more than $10,000 each per annum for the services which they rendered. We contend that the factors considered by the Tax Court substantiate its decision.

The Tax Court properly took into consideration whether Cunningham and Morse had any special qualifications. *Patton* v. *Commissioner,* decided April 30, 1947 (1947 P-H T.C. Memorandum Decisions, par. 47,119), affirmed, 168 F. 2d 28 (C.A. 6th); *N. A. Woodworth Co.* v. *Commissioner,* decided April 20, 1945 (1945 P-H T.C. Memorandum Decisions, par. 45,137).

In the *Woodworth* case, for example, the court found a large salary reasonable where the spectacular growth of the corporation was due largely to the special training and abilities of the employee. Neither Morse nor Cunningham had any particular qualifications for the work they did. Both had been in business before, but that is about the most that can be said, since their former business experience was entirely unrelated to taxpayer's business. Their previous work had not particularly qualified either of them to operate a foundry.

Although both Morse and Cunningham put in long hours, the principal factor in the growth of the business

was the licensing agreement with ALCOA, coupled of course with the boom in demand for taxpayer's products as a result of the war. Mrs. Cunningham was the procuring cause of the agreement, and was reimbursed for her expenses. If further compensation for the procurement of the agreements is due, it is due her, not Cunningham or Morse. Without the licensing agreement, the growth of the business would most probably have been slower. It is well settled that the Tax Court may take into account the abnormal growth of business because of war conditions. *Locke Machine Co.* v. *Commissioner,* decided March 7, 1947 (1947 P-H T.C. Memorandum Decisions, par. 47,067), affirmed, 168 F. 2d 21 (C.A. 6th), certiorari denied, 335 U.S. 861; *Wood Roadmixer Co.* v. *Commissioner,* 8 T.C. 247; *Hewitt Rubber Co.* v. *Commissioner,* decided November 28 1947 (1947 P-H T.C. Memorandum Decisions, par. 47,317); *Cooked Foods, Inc.* v. *Commissioner,* decided July 25, 1947 (1947 P-H T.C. Memorandum Decisions, par. 47,223). The mere use of a product in connection with the prosecution of the war is not ground for disallowing compensation for procuring war orders, where extraordinary or special effort is required or where expansion is due almost entirely to the industry and ability of the officers of the business whose salaries are sought to be deducted. *Dixie Frosted Foods, Inc.* v. *Commissioner,* decided May 29, 1947 (1947 P-H T.C. Memorandum Decisions, par. 47,145). Accord: *N. A. Woodworth Co.* v. *Commissioner, supra.* But such facts are not present here. It is clear that the tremendous progressive increases in taxpayer's sales reflect war demand for airplane parts which taxpayer fabricated. Its sole business in 1942 was making airplane parts as a sub-contractor for aircraft plants engaged in war production. No figures appear for postwar years, but it is a fair surmise that taxpayer's

gross sales reflected the drop in aircraft demand in those years. And as the cases indicate, the Tax Court—quite properly so, in view of the Government's demands for revenue in the war years—as well as the Commissioner has been reluctant to credit deductions for large salary inreases where increased profits so clearly reflect war production activity.

It was proper for the Tax Court to take into account the fact that services were not the guiding factor in determining the amounts of salary Cunningham and Morse merited. Necessarily, to protect the revenue against spurious deductions, distributions under the guise of salary that are not salary cannot be allowed to be deducted as salary. Obviously, it is reasonable to reward long service by raises in salary, but hardly is it so when the increase is disproportionate. The moral obligations of the corporation may move it in its actions, but that obligation is insufficient to come within the grace of the deduction provided for reasonable compensation paid for services rendered. The testimony is varying on the extent to which services entered into a determination of amount. Cunningham stated that past performances and experience were the guiding factor, that the decision to award $24,000 per annum did not take into account what might ensue after that date (R. 164); he also stated that work in forming the corporation was taken into account (R. 165). His wife pointed out that the increase was authorized because her husband was accustomed to earning that much in the past. (R. 216.) The increase to $36,000 per annum, voted on the day taxpayer was notified that its license would be royalty free, is more transparent. Cunningham and his wife both testified that increased sales had a bearing on the increase. (R. 166,214.) There is no evidence showing a 50 percent increase in services rendered between January, 1942, and August 28, 1942.

It is significant that although 1942 was a year of unprecedented prosperity for taxpayer, no dividends were paid on its stock. Large increases in compensation to the officers of a corporation come in for close scrutiny where no dividends are paid. *Clinton Co.* v. *Commissioner,* decided May 17, 1945 (1945 P-H T. C. Memorandum Decisions, ¶ 45,175), affirmed, 159 F. 2d 102 (C.A. 7th). The Commissioner and the courts must maintain a sharp lookout for distribution of profits under the guise of salaries. Accord: *Twin City Tile & M. Co.* v. *Commissioner,* 32 F. 2d 229 (C.A. 8th), affirming 6 B. T. A. 1238. As the Tax Court pointed out below, the salaries paid Cunningham and Morse were in direct proportion to the stockholdings in taxpayer of the Morse and Cunningham families, holdings of equal amount. As it further stated (R. 60) "The equality of compensation paid to these two officers seems to us to be inconsistent with an intention to compensate them on the basis of the value of the services rendered * * *". As has been the result in other cases, the Tax Court properly looked through the pretense of salary payment aligned to stockholdings.[2] *Transportation Service Associates, Inc.* v. *Commissioner,* decided February 11, 1944 (1944 P-H T. C. Memorandum Decisions, ¶ 44,036), affirmed, 149 F. 2d 354 (C.A. 3d); *Crescent Bed Co.* v. *Commissioner,* 133 F. 2d 424 (C.A. 5th). The courts

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[2] The Tax Court was not precluded from inferring that the so-called compensation payments to Morse and Cunningham were in reality in part a distribution of profits in accord with the stockholdings of the two families by the fact that the Commissioner did not expressly so determine in his deficiency letter. *Heckett* v. *Commissioner,* 8 T. C. 841, 844, cited by taxpayer (Br. 37), involved an entirely different situation. The Commissioner did determine that $28,000 was excessive compensation and that $10,000 only was a reasonable allowance for the services rendered by each officer and any considerations relevant to that issue are properly considered. As the above discussion shows, the courts have repeatedly appraised the so-called salary payments in the light of whether a distribution of profits might be included.

have been reluctant to question the motives of boards of directors in awarding salaries. The action of a board is presumptively proper. But this presumption depends upon the relationship between the employees and the board; where the board is not independent or where there is a closely held corporation, the reluctance disappears. *L. E. Pinkham Med. Co.* v. *Commissioner,* 128 F. 2d 986 (C.A. 1st), certiorari denied, 317 U. S. 675; *Glenshaw Glass Co.* v. *Commissioner,* decided October 15, 1946 (1946 P-H T. C. Memorandum Decisions, ¶ 46,245), affirmed, October 21, 1947 (C.A. 3d), certiorari denied, 333 U. S. 842.

In his brief (p. 38), taxpayer relies on *Coastal Stevedoring Corp.* v. *Commissioner,* decided May 12, 1944 (1944 P-H T. C. Memorandum Decisions, ¶ 44,158), as being substantially parallel to the case at bar. It has points of similarity, but may be distinguished on the basis that therein there was a distribution of dividends; there is no evidence of such a distribution herein. The Tax Court also emphasized in the *Coastal Stevedoring* case that the duties of the officers compensated had increased commensurate with their salary increases. Such a conclusion would not, we submit, be justified herein.

It is clear from the foregoing that taxpayer has not sustained its burden of showing that the determinations of the Commissioner and of the Tax Court were wrong. There is ample authority for the Tax Court to have taken into account the elements in reasonability that it did, and there is ample evidence to sustain its findings. It may well be said that no one of the facts herein is sufficient to indicate that the salaries taxpayer sought to deduct were not reasonable with the Code provision providing a deduction, but an examination of all the facts makes it clear beyond question that what was attempted here was a distribution of profits to the stock-

holders in the guise of salary payments. Against just such a manipulation the courts have protested. In the circumstances here we believe that the only conclusion possible was the one reached by the Tax Court, that the salaries paid were unreasonable for the services rendered and that the Commissioner's determination of a reasonable salary for each officer should be sustained. Even if any other conclusion were possible, it cannot be said that the conclusion of the Tax Court was clearly erroneous, and therefore it is conclusive upon the Court herein.

CONCLUSION

In view of the foregoing, it is respectfully submitted that the Tax Court committed no error of law and that the Tax Court's finding as to reasonability is not only not clearly erroneous but is the only finding that could have been made in the circumstances.

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JUNE, 1949.

APPENDIX

Internal Revenue Code:

SEC. 23 [as amended by Sec. 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

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(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 780 [as added by Sec. 250 of the Revenue Act of 1942, *supra,* and amended by Sec. 3 of the Tax Adjustment Act of 1945, c. 340, 59 Stat. 517]. POST-WAR REFUND OF EXCESS PROFITS TAX.

(a) *In General.*—The Secretary of the Treasury is authorized and directed to establish a credit to the account of each taxpayer subject to the tax imposed under this sub-chapter, for each taxable year ending after December 31, 1941 (except in the case of a taxable year beginning in 1941 and ending before July 1, 1942), and not beginning after December 31, 1943, of an amount equal to 10

per centum of the tax imposed under this subchapter for each such taxable year. For the purposes of this Part, in the case of a taxpayer whose tax is determined under section 710 (a)(3), the term "tax imposed under this subchapter" means the excess of the tax imposed by such section 710 (a)(3) over the tax that would be imposed if such section 710(a)(3) were not applicable.

(b) *Application of Credit to Purchase of Bonds.*—Within three months after the payment of the amount of the excess profits tax shown on the return for a taxable year to which subsection (a) applies, if the payment is made before July 1, 1945, there shall be issued to and in the name of the taxpayer bonds of the United States in an aggregate amount equal to 10 per centum of the tax paid in respect of which a credit is provided under subsection (a), and the credit established under subsection (a) for such taxable year is hereby made available for the purchase of such bonds.

* * * * *

(26 U.S.C. 1946 ed., Sec. 780.)

SEC. 781 [as added by Sec. 250 of the Revenue Act of 1942, *supra,* and as amended by Sec. 3 of the Tax Adjustment Act of 1945, *supra*]. SPECIAL RULES FOR APPLICATION OF SECTION 780.

(a) *Effect of Deficiencies.*—If a deficiency in respect of the excess profits tax for any taxable year for which a credit is provided in section 780 (a) is paid by the taxpayer before July 1, 1945, an amount of such credit equal to 10 per centum of the excess of the tax imposed by this subchapter on the basis of which the deficiency was determined, over the tax imposed by this subchapter as previously computed and paid shall be available, as provided in section 780 (b), for the purchase of bonds as provided under such section, and there shall be issued to the taxpayer bonds under such section in an amount equal to such excess and with the same maturity as in the case of bonds issued

with respect to the taxable year with respect to which the deficiency is determined.

* * * * *

(c) *Tax Payments After Cut-Off Date.*—In the case of a payment of the tax imposed by this subchapter shown on the return for any taxable year for which a credit is provided in section 780 (a), or the payment of a deficiency in respect of such tax for any such taxable year, on or after July 1, 1945, the amount of the credit under section 780 (a) for such taxable year attributable to such payment shall be paid the taxpayer in cash. No interest for the period after December 31, 1945, shall be assessed or collected on that portion of the tax or deficiency so paid equal to the credit under section 780 (a) attributable to such payment. If after January 1, 1946, there is any credit under section 780 (a) remaining in favor of the taxpayer attributable to any taxable year for which a credit is provided in section 780 (a), such remainder shall be paid to the taxpayer in cash. No amount of any payment made under this subsection to a taxpayer shall be included in gross income.

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(26 U.S.C. 1946 ed., Sec. 781.)

SEC. 1103. ORGANIZATION.

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(b) *Designation of Chairman.*—The Board shall at least biennially designate a member to act as chairman.

(c) *Divisions.*—The chairman may from time to time divide the Board into divisions of one or more members, assign the members of the Board thereto, and in case of a division of more than one member, designate the chief thereof. If a division, as a result of a vacancy or the absence or inability of a member assigned thereto to serve thereon, is composed of less than the number of

members designated for the division, the chairman may assign other members to the division or direct the division to proceed with the transaction of business without awaiting any additional assignment of members thereto.

(d) *Quorum.*—A majority of the members of the Board or of any division thereof shall constitute a quorum for the transaction of the business of the Board or of the division, respectively. A vacancy in the Board or in any division thereof shall not impair the powers nor affect the duties of the Board or division nor of the remaining members of the Board or division, respectively.

(26 U.S.C. 1946 ed., Sec. 1103.)

SEC. 1114 [as amended by Sec. 503 of the Revenue Act of 1943, c. 63, 58 Stat. 21]. ADMINISTRATION OF OATHS AND PROCUREMENT OF TESTIMONY.

* * * * *

(b) *Commissioners.*—The Presiding Judge may from time to time by written order designate an attorney from the legal staff of the court to act as a commissioner in a particular case. The commissioner so designated shall proceed under such rules and regulations as may be promulgated by the court. The commissioner shall receive the same travel and subsistence allowances now or hereafter provided by law for commissioners of the Court of Claims.

(26 U.S.C. 1946 ed., Sec. 1114.)

SEC. 1116. HEARINGS.

Notice and opportunity to be heard upon any proceeding instituted before the Board shall be given to the taxpayer and the Commissioner. If an opportunity to be heard upon the proceeding is given before a division of the Board, neither the taxpayer nor the Commissioner shall be entitled to notice and opportunity to be heard before the Board upon review, except upon a specific

order of the chairman. Hearings before the Board and its divisions shall be open to the public, and the testimony, and, if the Board so requires, the argument shall be stenographically reported. The Board is authorized to contract (by renewal of contract or otherwise) for the reporting of such hearings, and in such contract to fix the terms and conditions under which transcripts will be supplied by the contractor to the Board and to other persons and agencies.

(26 U.S.C. 1946 ed., Sec. 1116.)

SEC. 1117. REPORTS AND DECISIONS.

(a) *Requirement.*—A report upon any proceeding instituted before the Board and a decision thereon shall be made as quickly as practicable. The decision shall be made by a member in accordance with the report of the Board, and such decision so made shall, when entered, be the decision of the Board.

(b) *Inclusion of Findings of Fact or Opinions in Report.*—It shall be the duty of the Board and of each division to include in its report upon any proceeding its findings of fact or opinion or memorandum opinion. The Board shall report in writing all its findings of fact, opinions and memorandum opinions.

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(26 U.S.C. 1946 ed., Sec. 1117.)

SEC. 1118. PROVISIONS OF SPECIAL APPLICATION TO DIVISIONS.

(a) *Hearings, Determinations, and Reports.*—A division shall hear, and make a determination upon, any proceeding instituted before the Board and any motion in connection therewith, assigned to such division by the chairman, and shall make a report of any such determination which constitutes its final disposition of the proceeding.

(b) *Effect of Action by a Division.*—The report of the division shall become the report of the Board within 30 days after such report by the division, unless within such period the chairman has directed that such report shall be reviewed by the Board. Any preliminary action by a division which does not form the basis for the entry of the final decision shall not be subject to review by the Board except in accordance with such rules as the Board may prescribe. The report of a division shall not be a part of the record in any case in which the chairman directs that such report shall be reviewed by the Board.

(26 U.S.C. 1946 ed., Sec. 1118.)

'reasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.23(a)-6. *Compensation for Personal Services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the exces-

sive payments are a distribution of earnings upon the stock. (b) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

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